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Supreme Court, U.S.
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No. 91-1592

In the Supreme Court of the United States

OCTOBER TERM, 1991

H.G.A. CINEMA TRUST,
BURTON W. KANTER, TRUSTEE, PETITIONER

v.

UNITED STATES DEPARTMENT OF JUSTICE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether a long-term promissory note constitutes genuine indebtedness when the taxpayer's obligation to make "payments" on the note is contingent upon its receipt of an equivalent amount of "rent" from another party in a circular transaction.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-14) is reported at 950 F.2d 1357. The opinion of the Tax Court (Pet. App. 15-35) is reported at 57 T.C.M. (CCH) 1066.

JURISDICTION

The judgment of the court of appeals was entered on December 27, 1991. The petition for a writ of certiorari was filed on March 26, 1992. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner held a 5.56% interest in the profits and losses of SLG, a limited partnership, during the

1978 through 1981 tax years. During this period, SLG engaged in two separate transactions involving the purchase and leaseback of computer equipment. The parties to the first transaction were Funding Systems Leasing Corporation (Funding), Pluto Leasing Corp. (Pluto) and SLG. The parties to the second transaction were O.P.M. Leasing Services, Inc. (O.P.M.), Knight Leasing Corporation (Knight) and SLG (Pet. App. 2).

a. The first transaction was arranged as follows: (i) On June 30, 1978, Pluto purchased the computer equipment from Funding for $2,700,000. The purchase price consisted of $5,000 in cash, $25,000 in a noninterest-bearing promissory note due on July 31, 1978, and $2,670,000 in a limited recourse promissory note to be paid in 96 monthly installments with a 10.4% annual interest rate (Pet. App. 2-3). (ii) On the same date, Pluto leased the computer equipment back to Funding for a term extending through June 30, 1986 (the same term as the $2,670,000 promissory note). In the lease, Funding agreed to pay rent to and to indemnify Pluto and hold it harmless from any loss incurred as a result of any breach by Funding of the lease (*id.* at 3). (iii) On the same date, SLG purchased the computer equipment from Pluto for $2,705,000 ($5,000 more than the purchase price in the transaction between Pluto and Funding). The terms of payment were otherwise identical in substance: $5,000 in cash, $25,000 by negotiable promissory note due on July 31, 1978, $5,000 by negotiable promissory note due on March 31, 1979, and $2,670,000 by long-term promissory note containing essentially the same terms as Pluto's long-term note to Funding. SLG anticipated that the cash flow generated by these transactions would be $200 per month, which represents the difference be-

tween the rent due on the lease between Funding and Pluto (the rights in which were assigned by Pluto to SLG) and the monthly payments on SLG's long-term note to Pluto (*id.* at 3-4).

The long-term note given by SLG to Pluto contained provisions entitled "Deferral" and "Extension, Set-Off and Discharge" (Pet. App. 4). Under the deferral provision, if the lease was terminated on account of an event of default, payment of the note was deferred until June 30, 1993 (*ibid.*). The computer equipment was expected to have virtually no residual value on June 30, 1993 (*id.* at 7). An event of default included the filing of a bankruptcy petition (*id.* at 11). Under the setoff provision, SLG could defer its note payments to the extent of any unpaid rental payments, and these deferred amounts correspondingly would reduce the unpaid principal and interest outstanding at the termination of the lease (*id.* at 4).

b. On June 30, 1978, O.P.M., Knight, and SLG entered into a transaction for the sale and leaseback of computer equipment that was identical in substance to the Funding-Pluto-SLG transaction. The Knight-O.P.M. lease contained an indemnification clause identical to that contained in the Funding-Pluto lease, and SLG's long-term note to Knight contained provisions identical to those in its note to Pluto (Pet. App. 5). SLG anticipated that its transactions with O.P.M. and Knight would generate a monthly cash flow of $160, which represented the excess of the rental payments from the Knight-O.P.M. lease over SLG's monthly payments on its long-term note (*id.* at 6).

2. In 1981, three years after these transactions commenced, O.P.M. and Funding filed bankruptcy petitions under Chapter 11 of the Bankruptcy Reform

Act of 1978. In the bankruptcy proceedings, SLG, Pluto, and Funding agreed to an assumption, modification, and compromise of controversies with respect to the sale and leaseback transactions, as did SLG, Knight, and O.P.M. The bankruptcy court approved the modifications (Pet. App. 6).

These modifications provided that SLG's cash flow of $200 and $160 per month, including amounts past due and amounts not yet due, would become unsecured general claims against Funding and O.P.M., respectively. Funding's and O.P.M.'s lease payments were reduced to eliminate the cash flow to SLG. As a result, the lease payments and note payments were thereafter to be of equal amounts. The modifications also provided that the rent and note payments were to offset each other, and the order in which the rental and note payments were due was reversed (Pet. App. 6). Even with these modifications, however, the "closed circularity of the offsetting rent and debt obligations persisted" (*id.* at 13).

3. In 1979, 1980, and 1981, SLG reported rental income, interest expense, and depreciation from the computer sale-leaseback transactions. As a partner in SLG, petitioner deducted its distributive share of the partnership's claimed losses and investment interest expense on its income tax returns (Pet. App. 7). The Commissioner disallowed all income and deductions from the sale-leaseback transactions and imposed additional interest and various penalties under the Internal Revenue Code (*id.* at 7-8). Petitioner sought review of these deficiencies in the Tax Court.

4. The principal issue considered in the Tax Court was "whether certain long-term promissory notes of petitioner's partnership issued in connection with the purchase of computer equipment represent valid in-

debtedness" (Pet. App. 16).[1] The court concluded (*id.* at 28) that the notes were not valid indebtedness because, under the deferral provision, SLG had the right to defer any payment to the extent that rental payments from Funding or O.P.M. were overdue and, under the set-off provision, these deferred amounts would reduce the unpaid principal and interest outstanding on the notes at the termination of the lease. As the Tax Court observed, "SLG's obligation to make payments on the long-term notes * * * was specifically subject to Funding's or O.P.M.'s paying the rent due in the lease agreements" (*ibid.*). This conclusion was reinforced by the indemnity clause in the lease, under which the lessor (SLG) would be indemnified against any loss (including unpaid rent) resulting from Funding's or O.P.M.'s default. The Tax Court thus concluded that SLG's note obligations were payable solely out of rental receipts (*id.* at 27-28).

The Tax Court rejected HGA's argument that there was nonetheless genuine indebtedness because a trustee in bankruptcy could reject the leases. The court considered implausible the argument that SLG entered these transactions expecting the leasing corporations to declare bankruptcy, because the evidence suggested that bankruptcy was not likely in 1978, 1979, or 1980. Furthermore, the trustee-in-bankruptcy and debtor-in-possession for O.P.M. and Funding did not, in fact, reject the leases or attempt to

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[1] As noted by the court of appeals (Pet. App. 8), the Commissioner also argued in the Tax Court that even if the SLG notes represented genuine indebtedness, the deductions in question should still be disallowed because petitioner was not "at risk" with respect to its pro rata share of these notes under 26 U.S.C. 465(b)(3) and (4). Neither the Tax Court nor the court of appeals found it necessary to address these contentions.

collect on SLG's notes when the corporations declared bankruptcy. To the contrary, the modifications of the notes, approved by the bankruptcy court, continued the circularity of the offsetting rent and debt obligations. Finally, the court observed that, had the leases been disaffirmed, SLG had substantial legal arguments that the notes were not recourse and that the underlying obligations were wholly dependent on the receipt of rentals under the leases (Pet. App. 29-31).

5. The court of appeals affirmed (Pet. App. 1-4). The court agreed with the Tax Court's determination that SLG's obligation to make payments on the long-term notes was not unconditional; instead, it was subject to the leasing corporations' promises to pay rent (*id.* at 11-12). The court also agreed with the Tax Court's determination that the potential effect of a bankruptcy did not transform SLG's ephemeral "obligations" into genuine indebtedness (*id.* at 12-13). The court therefore concluded that SLG's notes "did not represent valid debt" and that the amount of the notes thus "can neither be included in basis nor support a deduction for interest expense" (*id.* at 13).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or of any other court of appeals. Moreover, the new provisions of Section 469 of the Internal Revenue Code, effective for tax years after 1986, specifically bar a claim of deductions for transactions of the type involved in this case. The issue presented in this case thus lacks continuing general importance. Further review is therefore not warranted.

1. The court of appeals correctly held that SLG's long-term notes do not represent genuine indebtedness. Genuine indebtedness consists of the "uncondi-

tional and legally enforceable obligation for the payment of money." *Autenreith* v. *Commissioner*, 115 F.2d 856, 858 (3d Cir. 1940). Contingent or speculative obligations do not represent genuine indebtedness and cannot be included in a taxpayer's basis. See *Durkin* v. *Commissioner*, 872 F.2d 1271, 1276 (7th Cir.), cert. denied, 493 U.S. 824 (1989); *Brountas* v. *Commissioner*, 692 F.2d 152, 157-158 (1st Cir. 1982), cert. denied, 462 U.S. 1106 (1983).

The terms of the notes involved in this case demonstrate that SLG did not have an unconditional obligation for the payment of money. Under the deferral provision, SLG had the right to defer any payment to the extent that rental payments from Funding or O.P.M. were overdue. Under the set-off provision, these deferred amounts reduced the unpaid principal and interest outstanding on the notes at the termination of the lease. As the courts below correctly concluded, "under the terms of [the] long-term notes, SLG had no obligation to 'pay' on the notes except to the extent that Funding or O.P.M. paid rent" (Pet. App. 11; see *id.* at 28).

2. Contrary to petitioner's contention (Pet. 9-14), the decision in this case does not conflict with *Emershaw* v. *Commissioner*, 949 F.2d 841 (6th Cir. 1991). In *Emershaw*, the "one issue on appeal [was] whether the Emershaws were 'at risk' within the meaning of 26 U.S.C. § 465, with respect to their *pro rata* share of a 'partial recourse promissory note' issued by LEA." 949 F.2d at 842-843.[2] By contrast, in

[2] The particular subdivision of Section 465 at issue in *Emershaw* was (b)(4), which provides that a taxpayer is not at risk "with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements." 26 U.S.C. 465(b)(4). The *Emershaw* court rejected the Commissioner's contention

this case, "the sole issue * * * is whether SLG's long-term promissory notes constituted a valid and binding indebtedness" (Pet. App. 10). Because the court of appeals decided this threshold issue in favor of the Commissioner, the court did not need to reach, and did not reach, the Section 465(b)(4) issue decided in *Emershaw*. See note 1, *supra*.

Petitioner acknowledged the separate character of these two issues in its reply brief in the court of appeals, where it observed (at 16) that "the Tax Court did not deal with any of the issues surrounding the possible application of Section 465." See also *id.* at 25 ("the Tax Court did not reach, and did not have to reach, the alternative issues of Section 465"). Because the court of appeals applied the same analysis that the Tax Court did, it is evident, as petitioner said below, that this case does "not deal with any of the issues surrounding the possible application of Section 465."

To be sure, the leasing corporations filed for bankruptcy both in this case and in *Emershaw*. Because the terms of the notes differed in the two cases, however, the bankruptcies had different effects on the taxpayers' liability on these notes. In *Emershaw*, there was no indication that the long-term note contained any deferral or set-off conditions with respect to payment. In the absence of such conditions, the Sixth Circuit concluded (949 F.2d at 848) that the leasing corporation's insolvency could render the taxpayers and other LEA partners personally liable for their proportionate share of the LEA note. In this

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that "the circular, off-setting group of obligations established by the sale-leaseback transaction at issue [there] [was], by itself, a loss-limiting arrangement within the meaning of § 465(b)(4)." 949 F.2d at 848.

case, however, SLG's long-term notes contained deferral and set-off provisions which, even after the bankruptcy modifications, made SLG's liability on the notes merely a conditional one (Pet. App. 30).

Moreover, contrary to petitioner's contention (Pet. 14), the Seventh Circuit did not ignore the fact of bankruptcy in its opinion. Instead, the court held that the consequences of the bankruptcies *supported* the holding that the long-term notes did not represent genuine indebtedness (Pet. App. 13). This conclusion is correct because SLG "retained the offset and deferral rights contained in the original notes" (*id.* at 30) and therefore continued to lack an unconditional obligation to pay the amounts of those notes.[3]

3. The issue addressed in this case lacks significant, recurring importance. For tax years after 1986, Section 469 of the Internal Revenue Code operates to bar deductions generated from transactions of the type involved in this case.[4] Section 469 generally provides that, to the extent that deductions from passive trade or business activities exceed income from such passive activities, they may not be offset against other income. See 26 U.S.C. 469; S. Rep. No. 313, 99th Cong., 2d Sess. 718 (1986) (1986-3 CB (Vol. 3) 1, 718). A "passive activity" is any activity involving the conduct of any trade or business in which, as here, the taxpayer does not materially participate. 26 U.S.C. 469(c)(1).[5] For tax years after 1986, the

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[3] Petitioner's claim (Pet. 10) of a conflict between *Emershaw* and *Baldwin* v. *United States*, 904 F.2d 477 (9th Cir. 1990), is irrelevant to the question whether the Court should grant certiorari in this case.

[4] Section 469 was added to the Code by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 501, 100 Stat. 2233.

[5] See also 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates & Gifts* ¶ 28.1 (2d ed. 1989) ("A limited

result reached in this case by the determination whether the transaction represents genuine indebtedness may be reached directly under Section 469 by disallowing the claimed deduction as an excessive passive loss. There is thus no continuing importance to the specific issue addressed in this case.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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partnership interest in a partnership engaging in an equipment leasing business is a typical example of a passive activity [for Section 469 purposes].").

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